

Southwest Economy



Empty Spaces: Are Texas Office Markets on the Road to Recovery?

Office markets are cyclical by nature, but in Texas the booms tend to be larger and the busts seem to last longer. In the past, Texas' office construction was sometimes driven by external factors—such as oil prices and tax law changes—in addition to economic fundamentals. However, beginning in the 1990s, Texas real estate was driven more by supply and demand.

Economic prosperity in the 1990s, partly thanks to the high-tech boom, breathed life into Texas office markets that had been stagnant since the mid-1980s bust. Demand for office space rose strongly, rents increased at double-digit rates and construction cranes dotted the Texas skyline.

The national recession that began in March 2001, along with the high-tech bust and catastrophic events of 9/11, took a toll on the Texas economy, however. The downturn hit harder and lasted longer in Texas than elsewhere in the country. As firms downsized, office vacancies in Texas markets climbed quickly and rents began falling.

(Continued on page 2)

*INSIDE:
Domestic Policy
No Match for Trade
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Supply Chain Management: The Science of Better, Faster, Cheaper

Over the past 20 years, real GDP growth in the United States has become strikingly less volatile. Extreme movements in output occur far less often today, and there have been only two relatively mild recessions since 1982. In addition, about 10 years ago productivity growth began to accelerate. The average annual productivity growth rate since 1995 is about double that experienced from 1973 to 1995.

Improved economic stability and accelerating productivity growth have important policy implications. Specifically, accelerating productivity ultimately leads to higher living standards and fewer and milder periods of declining output. This makes the economy more resilient and flexible. Together, rising

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How do Texas office markets stack up currently? At just over 24 percent vacancy, Dallas tops the list of U.S. cities with the highest office vacancy rates. With a vacancy rate near 20 percent, Austin's office market is still in need of tenants. Houston's office sector didn't fare as badly in the most current recession, but its vacancy rate is still above the national average.¹

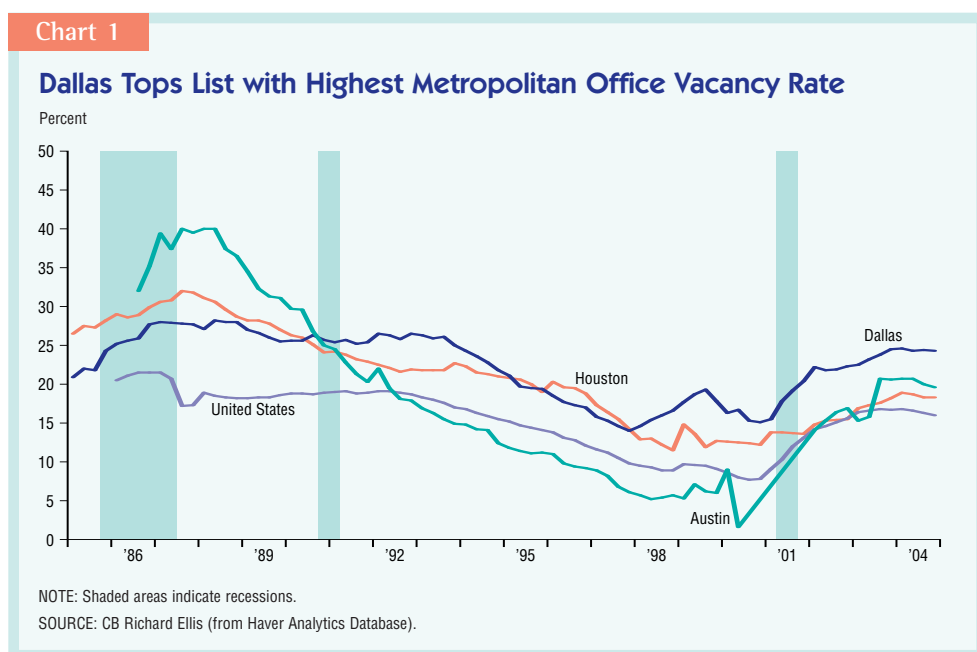
Are Texas office markets poised for a rebound? The outlook is murky. Employment growth and corporate relocations are the engines that drive Texas office demand, and these haven't revved up much during this recovery. Texas job growth has lagged the nation during the current recovery and is well below its historical pace. While some corporate relocations have been announced, the pace pales in comparison with that of the early 1990s.

In this article I look at current vacancy rates and employment growth in industries most important for office demand. I then compare these figures with vacancy and employment data from past real estate cycles to gain perspective on prospects for recovery in Texas office markets.

The 2001 Recession: Bad Timing for Texas Office Markets

The 1990s were good times for Texas real estate. Texas' central location, low cost of living and doing business, abundant land and multiple modes of transportation attracted businesses and people to the state. The state's booming economy fueled the demand for office space, eliminating the overhang from the 1980s and even spurring the need for new construction. (See the box titled "Office Real Estate Cycles in Texas: Some History.") Office vacancy rates fell from 1990 highs of between 25 and 30 percent to single digits in Austin and the mid-teens in Dallas and Houston by 2000 (*Chart 1*).

As the U.S. and Texas economies began to slow in 2000, office vacancy rates began edging up and construction eased. However, the events of 9/11, combined with the high-tech bust and a national recession, blindsided Texas office markets. The Texas economy was hit especially hard by the downturn because much of its growth in the previ-



ous 10 years had come from expansion of the high-tech sector. As firms downsized, demand for office space vanished.

Although the U.S. economy emerged from its downturn in late 2001, the Texas economy remained mired in recession until mid-2003.² The Dallas and Austin economies, which witnessed the fastest growth of the state's major metros during the '90s, were hit tremendously hard in the prolonged Texas downturn. The Dallas/Fort Worth metroplex lost about 132,000 jobs between the end of 2000 and December 2003. Roughly 30,000 of these losses came from the information sector, while 48,000 were eliminated from trade and transportation. Austin's manufacturing sector (which includes semiconductor production) eliminated almost 28,000 jobs between December 2000 and December 2003, while the information sector fell by 5,000 jobs.³

Because the high-tech bust was so pronounced in Dallas and Austin, these cities witnessed the biggest hit to their office markets. Dallas, known in the 1990s for its large concentration of telecom jobs, saw its office vacancy rate jump from a low of 15.1 percent in fourth quarter 2000 to 24.5 percent by fourth quarter 2003 as telecom firms laid off workers. Austin's vacancy rate soared from a low of near 2 percent to above 20 percent by the end of 2003.⁴

Houston's economy weathered the recession better than most of Texas'

major metros. As a result, vacancy rates in its office market didn't skyrocket as in Austin and Dallas. Nevertheless, Houston didn't come through the recession unscathed. Although overall employment didn't fall, some industries important to office demand, such as professional and business services and information, witnessed declines. Additionally, the Enron scandal left a prominent downtown skyscraper vacant and further reduced employment in oil-related services.⁵ By the end of 2002, Houston vacancy rates began to inch up at a faster pace than the U.S. average.

The Slow Recovery: Are We There Yet?

Although Texas emerged from recession in mid-2003, the recovery since then has been out of character for Texas, with tepid employment growth well below the state's historical pace. *Chart 2* shows Texas employment growth by major sector for the 12 months of 2004 compared with the same months during the recovery following the 1990–91 recession. Most sectors recorded positive job growth in 2004, yet less than half that seen in the previous recovery. Additionally, manufacturing and information—which are largely high tech oriented—continued to witness job declines last year.

The sluggish employment recovery has kept demand for office space at a

Office Real Estate Cycles in Texas: Some History

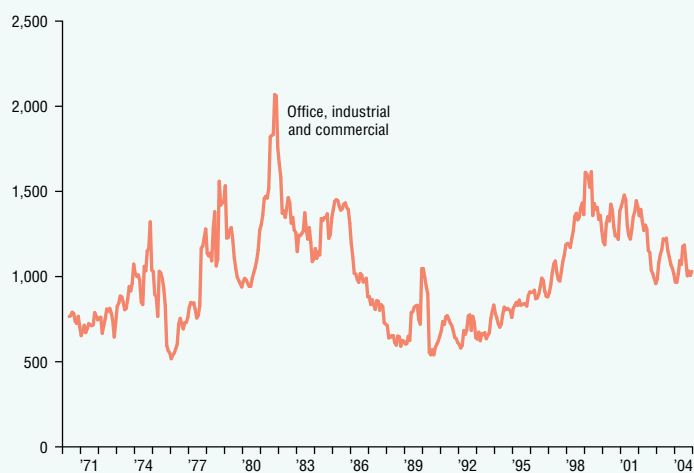
In the oil boom years of the mid- to late 1970s and early 1980s, Texas' office construction increased dramatically. At first, the strong pace of office construction seemed to be driven by healthy economic growth. In fact, a U.S. recession in 1974–75 was barely felt in Texas, thanks to upward spiraling oil prices that helped spur growth in Texas employment. Nonresidential construction more than quadrupled in Texas, while office vacancy rates fell to well below 10 percent.¹

In 1981 the U.S. economy entered a recession, and the Texas economy followed as oil prices began to fall. Despite the downward path of the economy, Texas non-residential construction continued to rise (*Exhibit 1*). The high level of construction activity in the early 1980s was motivated in part by the Economic Recovery Tax Act of 1981 (ERTA), which encouraged the flow of funds into commercial real estate. At the same time, it became easier to obtain financing due to new legislation that created a larger pool of funds for investing. Together, these factors caused construction to well outpace the demand for office space, leading to massive overbuilding.

In 1986, the bottom fell out of office real estate, and Texas became the center of the storm in a national real estate collapse. Declining oil prices had already sent the Texas economy into a prolonged recession. Moreover, the passage of the 1986 Tax Reform Act removed the advantages given to real estate by ERTA. Real estate investors

Exhibit 1 Office Construction Cycles Boom and Bust in Texas Texas Construction Contract Values

Real dollars*



*Seasonally adjusted, five-month moving average.

SOURCE: McGraw-Hill Construction Dodge.

were hurt as property values fell, and savings and loans and banks were in crisis as bad real estate loans created huge losses. Eventually the Resolution Trust Corp. took charge of failing savings and loans and banks. Its cash-only fire sales of foreclosed properties reduced the value of Texas office properties even further.²

The 1990s Rebound. A rebound in the Texas economy by 1987 and a prolonged dearth of construction through 1991 brought healthier fundamentals back to the Texas office sector. The U.S. recession of 1990–91 slowed the recovery slightly but had little impact on office vacancy rates in major Texas metros, which continued to edge lower.

By 1993, as the Texas economy picked up speed, demand for office space intensified, and vacancy rates came down further as construction remained low. Only by the mid- to late 1990s did office demand necessitate new construction, and developers responded eagerly, especially in Dallas.

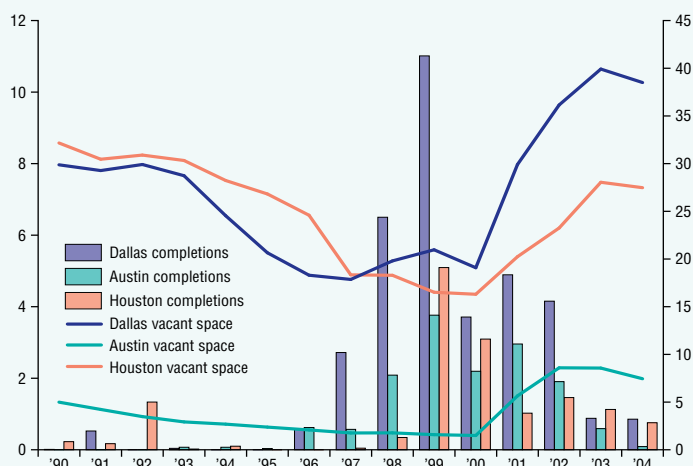
As Exhibit 2 shows, Dallas' vacant office space fell from 29.8 million square feet in 1990 to 17.8 million square feet by 1997, when office construction really began to pick up. Dallas office completions peaked in 1999 at 11 million square feet.³

Austin's office market benefited from the high-tech boom in the 1990s. As the industry took off, vacant office space fell from 4.9 million square feet in 1990 to 1.5 million square feet by 2000. Office space became scarce in the late 1990s as Austin's vacancy rate hovered near 5 percent, and developers began putting up office structures. The pickup in office construction occurred later in Houston, but by 1999, 5 million square feet of office space entered the market as the amount of

Exhibit 2 Office Market

Completions (millions of square feet)

Vacant space (millions of square feet)



SOURCE: Reis Inc.

vacant space fell to 16.5 million square feet.

Another Down Cycle: 2001. The 2001 recession—which lasted much longer in Texas than elsewhere in the United States—once again put Texas at the top of the office vacancy list. Dallas and Austin markets were hit especially hard, as their economies were strongly tied to high-tech industries that endured massive layoffs. The table shows vacancy rates among select U.S. metros. Austin and Dallas, which were among metros with the highest office vacancy rates in the country in the 1980s, are again near the top of the pack.⁴

Notes

¹ For further detail, see "The Texas Construction Sector: The Tail That Wagged the Dog," by D'Ann Petersen, Keith Phillips and Mine Yücel, Federal Reserve Bank of Dallas *Economic Review*, Second Quarter 1994.

² For a good explanation of how the boom and bust of Texas real estate impacts investors, see *Timing the Real Estate Market*, by Craig Hall, New York: McGraw-Hill, 2004.

³ Data provided by Reis Inc.

⁴ Dallas' vacancy rate consistently exceeds the nation's, which may be partially because Dallas is normally a high-growth metro area, and knowing this, developers put up more speculative space with the expectation that demand will catch up quickly.

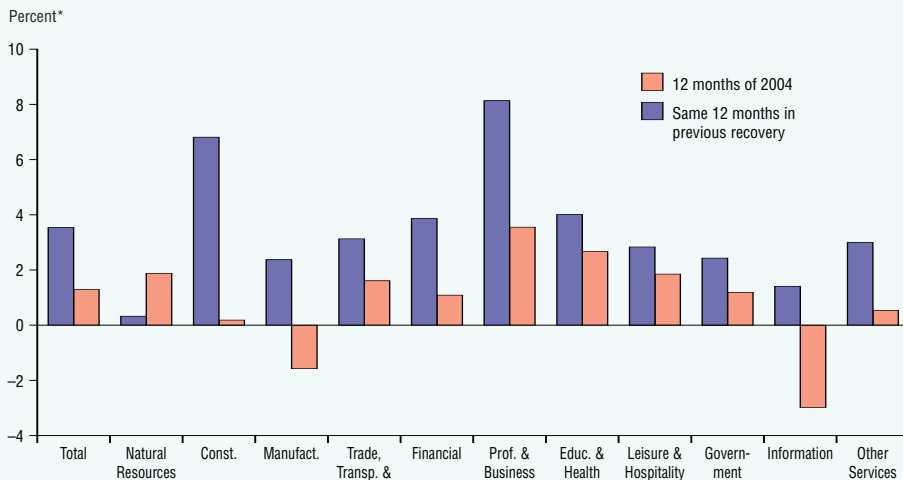
Office Vacancy Rates in Metropolitan Areas

	1986 4th Quarter (percent)	1990 1st Quarter (percent)	2000 3rd Quarter (percent)	2004 4th Quarter (percent)
United States	21.5	18.8	7.7	16.0
Austin	35.2	29.7	3.5*	19.6
Dallas	27.7	25.6	15.3	24.3
Houston	29.9	26.3	12.4	18.3
Atlanta	18.3	18.7	9.6	22.9
Chicago	17.3	15.5	8.8	16.2
Columbus	15.6	15.7	11.4	24.1
Denver	26.5	24.6	10.1	19.4
Los Angeles	17.3	15.9	11.1	13.4
Miami	21.1	22.9	8.6	13.5
New York	—	13.7	2.5	9.9
Philadelphia	14.4	15.0	7.9	15.9
Phoenix	26.4	27.6	9.9	17.0
San Diego	23.6	21.6	5.4	9.8
San Francisco	19.4	15.5	2.0	17.6
San Jose	26.6	14.4	1.1	18.4
Portland	19.2	16.9	7.3	13.7

*Approximate (missing data).

Chart 2

Texas Employment Not Growing as Quickly in This Recovery



*Seasonally adjusted, annualized rate.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

minimum. Moreover, although construction has eased in most metros, continued work on projects planned before the downturn has helped push vacancies upward. With almost 40 million square feet of empty office space in Dallas and 28 million square feet in Houston, office markets have a long way to go toward recovery.

Some positive signs have recently emerged in Texas office markets, however. Leasing activity has begun to stir, and net demand (absorption) has turned positive in some metros. Additionally, rents appear to be stabilizing after falling for the past four years. Are office markets poised for a quick rebound? Or will slow employment growth put the reins on the office recovery? Below is a look at how the major Texas markets compare and what their prospects for recovery look like.

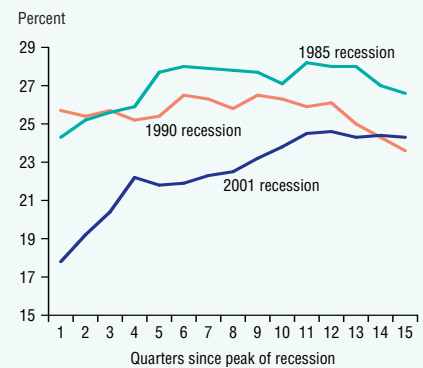
Dallas. Dallas currently tops the list of U.S. office markets for the highest vacancy rate. Although some suggest Dallas' rate is overstated, the available vacancy rate series gives a picture of how the city's office market has performed in past recoveries in comparison with the current one.⁶

Chart 3 shows Dallas' office vacancy rate from the peak of the 2001 U.S. recession through fourth quarter 2004 and the corresponding quarters in the 1990–91 U.S. recession and the Texas

recession of 1985–87. As the chart indicates, vacancies started out much lower in the 2001 recession, thanks to the strong economy of the 1990s, which helped reduce the space overhang of the 1980s. And vacancy rates during this recovery remained substantially lower than in the recoveries following the previous two recessions. Nevertheless, while rates started to edge down three years into the prior two recoveries, an improvement has yet to show up in the current cycle.

Chart 3

Metropolitan Office Vacancy Rates – Dallas



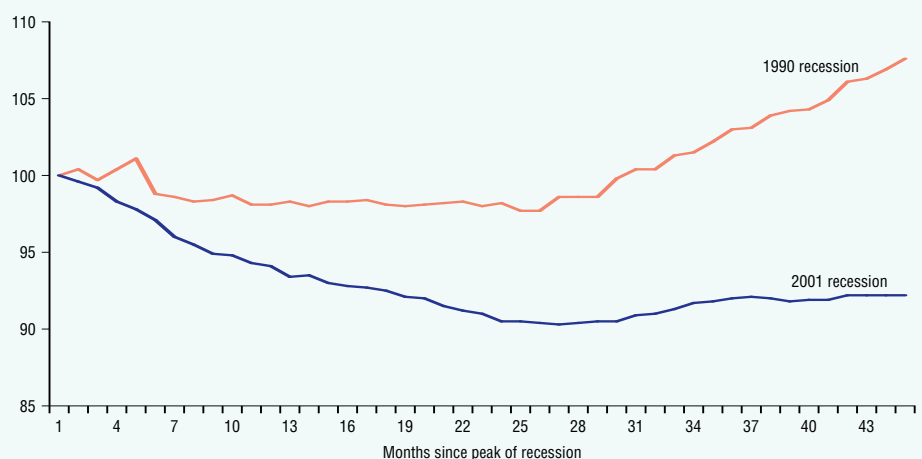
SOURCE: CB Richard Ellis (from Haver Analytics Database).

Why is Dallas' office recovery taking so long to materialize? Industry contacts report that slow job growth coupled with fewer corporate relocations during the current economic recovery are to blame.⁷ Indeed, employment growth in Dallas has been uncharacteristically sluggish, and the sectors of the Texas economy that usually boost office demand—including information, financial activities, and professional and business services—are expanding at a much slower pace than usual, with information jobs still falling.⁸ In 2004, Dallas' overall employment rose by a modest 0.7 percent, compared with 1.3 percent in

Chart 4

Dallas Office Employment Lags in Current Recovery

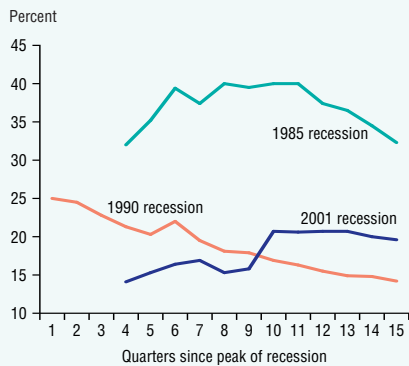
Index, recession peak = 100



SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Chart 5

Metropolitan Office Vacancy Rates – Austin



SOURCE: CB Richard Ellis (from Haver Analytics Database).

Texas overall. Dallas' office employment grew at a mere 0.9 percent pace.

Chart 4 plots office employment in Dallas from the peak of the 2001 recession through the end of 2004 and during the same months of the 1990 recession and subsequent recovery.⁹ Although Dallas office employment began accelerating 28 months into the previous recovery, we have yet to see much of a pickup in office jobs in the current recovery.

Given Dallas' vacant office stock of 38.5 million square feet and the slow pace of office employment growth, the recovery of the Dallas office market may be elusive until there is a substantial increase in hiring or relocations among service firms in office-related industries. Still, investors think Dallas is a good bet. 2004's large number of investment transactions indicates buyers expect Dallas' office market to improve rapidly once the recovery begins.¹⁰ Additionally, while corporate relocations remain below the pace set in the 1990s, they may be on the upswing. *Site Selection* magazine recently named the Dallas/Fort Worth metroplex the top market for corporate relocations and expansions in 2004. The ranking stems largely from Vought Aircraft's planned manufacturing expansion and Countrywide Financial's announcement of 5,000 new jobs for Richardson.

Austin. The office market in Austin is much smaller than that of Dallas or Houston, comprising only about one-fourth the space of its larger counter-

parts. However, Austin's market has experienced larger vacancy rate swings than the other two metros over the past several decades—reaching almost 40 percent in the late 1980s and falling to about 2 percent in the late 1990s. Currently, Austin's office vacancy rate stands at about 19 percent, 3 percentage points above the U.S. average.

Chart 5 shows Austin's office vacancy rate following the peak of the 2001 recession and during the same quarters in the previous two recoveries.¹¹ Vacancy rates in the current recovery remain well below those seen in the late 1980s and until recently were lower than those recorded in the 1990–91 recovery. Like Dallas, Austin's office market didn't begin improving as quickly in the current recovery as it did in past ones, although the vacancy rate did edge down in the last two quarters of 2004, which may signal the beginning of a turnaround.

The Austin office market's slow recovery stems from sluggish employment growth in industries that fuel office demand (*Chart 6*). Although Austin's office employment didn't fall as steeply as Dallas' during the 2001 recession, it has remained virtually flat for the past 20 months. In 2004, overall employment growth in Austin was 1.3 percent, while office employment grew at a slower 1 percent. This slow growth compares starkly with the previous recovery, when

Austin's office employment skyrocketed.

Positive net office demand of just over 1 million square feet in 2004 bodes well for an office recovery in Austin, but the turnaround may be slow unless office employment picks up. A return to the fast rate of economic growth Austin saw in the 1990s remains doubtful, but the presence of high-tech giants in Austin, and the metro's many economic and cultural amenities, will likely attract people and firms once again, especially if the high-tech industry reemerges from its current slump.

Houston. Houston's office market is in better shape than that of Austin or Dallas, with a current vacancy rate closer to the national average. Houston is less dependent on high-tech industries than Dallas and Austin, so its 2001 downturn was less drastic and its recovery has picked up some steam.

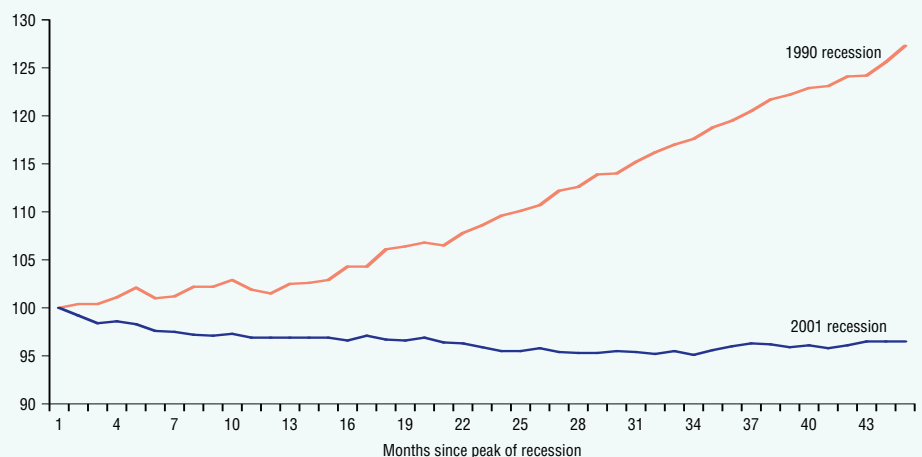
Chart 7 shows office vacancy rates in Houston from the peak of the 2001 recession and in the same quarters during the previous two recoveries. Houston's office vacancy rate remained below levels reached in the previous two recessions. Although the vacancy rate rose during the recent recovery, it remained below 20 percent. In recent quarters, the rate has edged down, a sign that the market may be on the road to improvement.

The good news for Houston's office market is that job growth in office

Chart 6

Austin Office Employment Is Flat in Current Recovery

Index, recession peak = 100



SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

employment has picked up, much like it did in the previous recovery, and is outpacing the growth of the metro's economy overall (*Chart 8*). Houston's 2004 job growth, while below its long-term average, was among the highest in the state (1.3 percent), and office employment increased at a much stronger 3 percent. If construction remains in check, Houston's office market may witness a speedier recovery than its counterparts in Austin and Dallas.

Summary

There are positive signs that office markets in Texas are turning the corner. Rent declines have slowed, leasing activity is picking up and investor interest is high. The recovery may be quicker in some metros than others, however, as office job growth is uneven across the state.

Houston holds the best prospects for recovery. Its office sector suffered less during the recession than its counterparts in Austin and Dallas, and office employment in Houston is growing at a good clip.

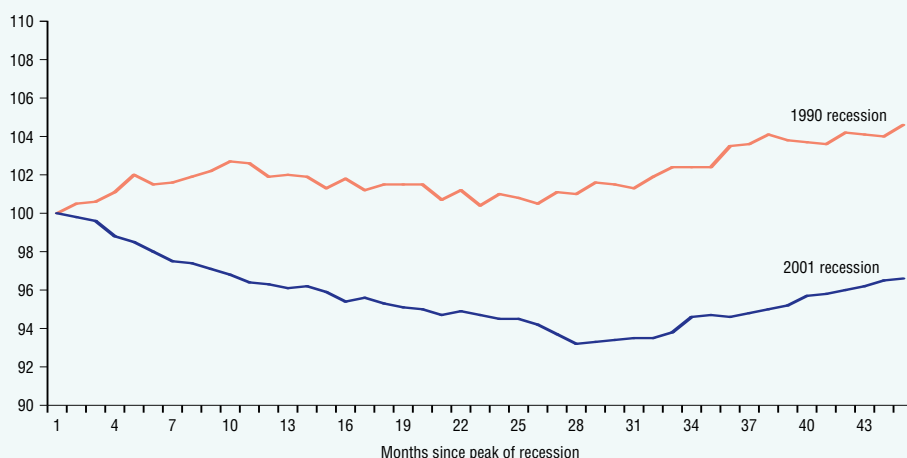
The Dallas and Austin economies have been slower to recover, and their office markets have deeper holes to dig out of. Currently, office employment in these two metros is growing at a snail's pace, which is not indicative of a quick turnaround.

Although the Texas economy is creating jobs again, the rate of job growth has been well below its historical trend.

Chart 8

Houston Office Employment Picks Up in Current Recovery

Index, recession peak = 100



SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

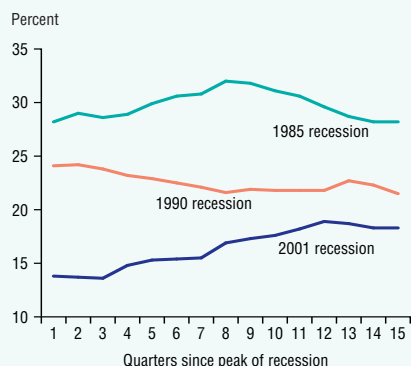
While long-term prospects for Texas job growth remain good—a result of the state's attractive combination of low costs and favorable business climate—leading economic indicators suggest another year of moderate growth for Texas. The Texas Leading Index suggests growth of about 2 percent in 2005, which, although still modest, is a pickup from 2004's slow pace. If office construction remains in check, the slightly higher job growth should help Texas office markets continue to improve, albeit slowly.

—D'Ann Petersen

Petersen is an associate economist in the Research Department of the Federal Reserve Bank of Dallas.

Chart 7

Metropolitan Office Vacancy Rates – Houston



SOURCE: CB Richard Ellis (from Haver Analytics Database).

Specifically, data are missing for all of 1985 and the first two quarters of 1986, as well as from third quarter 2000 through fourth quarter 2001.

⁵ Although Enron's demise introduced a large amount of space into the market in 2002, the loss of occupancy didn't show up in the vacancy rate data until the lease expired in first quarter 2004.

⁶ A recent story in the *Dallas Morning News* suggests that Dallas' downtown office vacancy may be exaggerated by up to 1 million square feet. See "A Flaw in the Numbers Game: Downtown Vacancy Rate Is Being Recalculated to Drop Boarded-Up Shells," by Steve Brown, *Dallas Morning News*, Feb. 4, 2005, p. 8D.

⁷ The Federal Reserve Bank of Dallas contacts business leaders in many industries, including real estate, in its Beige Book Survey. The Beige Book is released every six weeks and can be accessed through www.dallasfed.org.

⁸ Thanks to Mike Sobolik of Invesco Research and Eric Mackey of CB Richard Ellis for help in defining office employment. For the purposes of this article, office employment includes the broad NAICS supersectors of information, financial activities, and professional and business services. These broad sectors include the smaller industries of finance and insurance, real estate, professional services, management of companies, administration and support, and information.

⁹ Because employment classifications changed from SIC codes to NAICS beginning in 1990, we are unable to compare current office employment with that of the 1985 Texas recession and the subsequent recovery.

¹⁰ Although the 2001 recession weakened office market fundamentals, investment activity has been extremely heavy during the recovery. 2004 was a banner year for Dallas real estate investment, with metroplex transactions topping \$2 billion, according to data provided by CB Richard Ellis. The hot investment market has been fueled by low interest rates, real estate assets that have become more liquid and a weak stock market that helped real estate become a favored asset over some other investments. In addition, Dallas office space is a bargain compared with that on either coast. For further detail, see "Office Market Eyes Record Year," by Christine Perez, *Dallas Business Journal*, Nov. 19, 2004.

¹¹ Some data are missing. See note 5 for more detail.

Notes

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¹ CB Richard Ellis vacancy rate data available from Haver Analytics for these three Texas metros only.

² "Regional Update, February 2005," by Raghav Virmani, Federal Reserve Bank of Dallas *Expand Your Insight*, February 9, 2005, www.dallasfed.org/eyi/regional/archived/0502update.html.

³ For more detail on the impact of the recession and slow recovery on Texas' major metros, see "Economic Recovery Under Way in Major Texas Metros," by D'Ann Petersen and Priscilla Caputo, Federal Reserve Bank of Dallas *Southwest Economy*, March/April 2004.

⁴ The vacancy rate time series obtained through Haver Analytics from CB Richard Ellis is missing some quarterly data for the Austin metro.